



# **Transfer Pricing**

**August 2012**

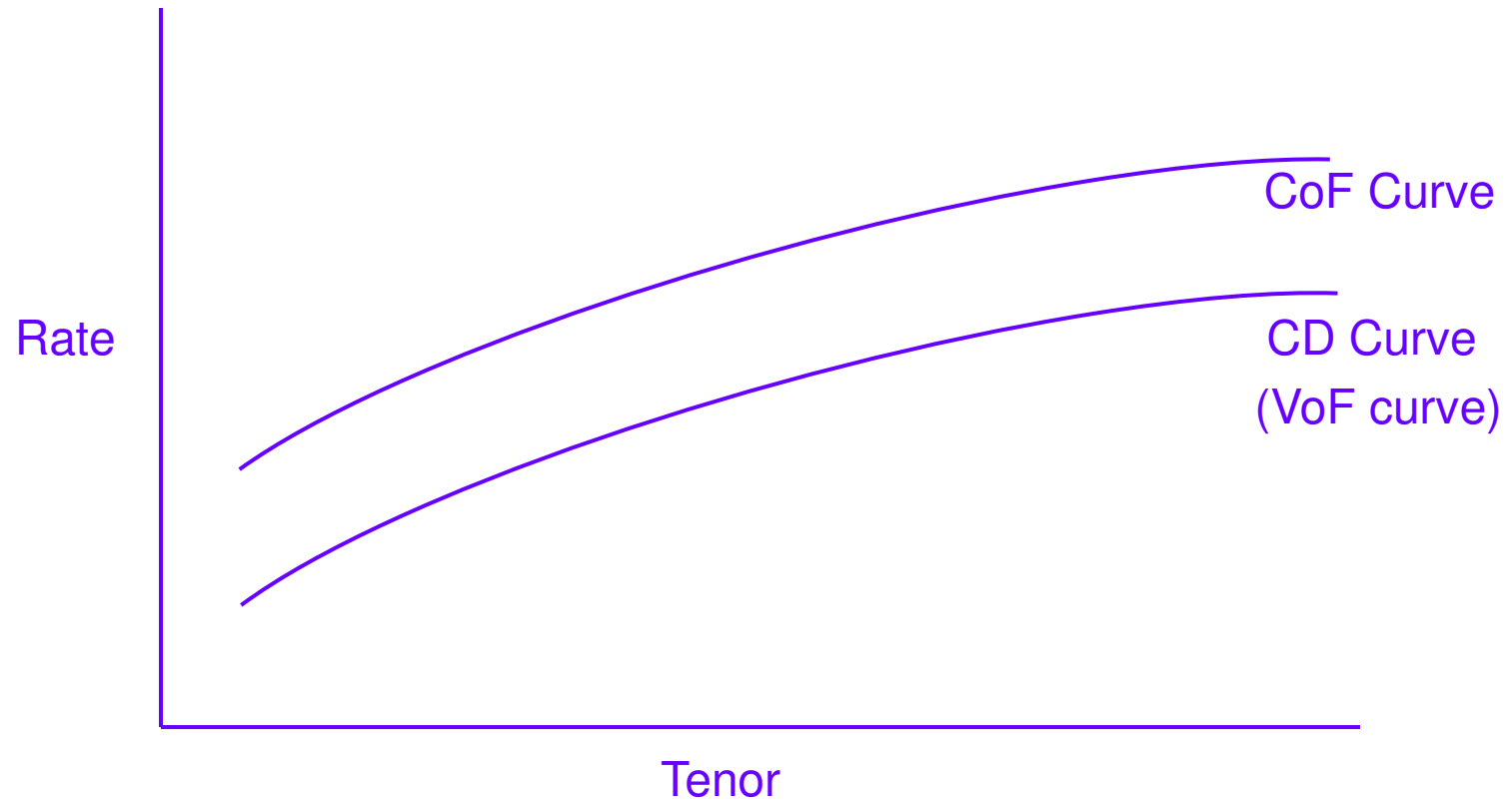
# A Suggested Starting Point



- Start with the CD Curve
- Adjust it for reserve costs

	01N	1m	3m	6m	12m	2yr	3yr
CD Rate	8.0	8.25	8.50	8.75	9.25	?	?
CRR 5%	0	0	0	0	0		
SLR 24%	8	8.10	8.10	8.10	8.10		
Reserve Adj VoF	8.56	8.88	9.23	9.59	10.29		

# Initial FTP Curve





- This curve is adjusted only for regulatory liquidity requirements – it is not **actionable liquidity** in the hands of the bank.
- Adjustments for balance sheet – is the bank generally lending money or borrowing money
  - ❖ The adjustments are necessarily subjective.
  - ❖ “BUT” constrained by opportunity costs

Eg: a very surplus balance sheet can always invest in Government Bonds, TBills, CBLO's... or into AAA rated CP's OR

A bank which is always borrowing may look at the cost of alternative sources of funding – BRDS, term money market, FCNR'B' swapped into INR.

- BUT ALCO to keep checking that the “marginal” cost of funds raised are being deployed profitably.



- Flexible, Dynamic approach required because of the illiquid and irrational market we deal in? but not flexible to 'principles'.
- Principle 1 : must observe 'marginal cost pricing'
  - ❖ Resist arguments in favour of lending based on 'average cost' or expedient arguments based on pockets of low cost funds (eg: Current accounts!)
- Principle 2 : do not subsidise products and businesses make the accounting transparent
  - ❖ a) lending at a loss making rate to a preferred customer
  - ❖ b) borrowing at a high cost from an important customer
  - ❖ c) aiming at loan growth by lowering CoF
- Overhead Costs – admin, Infrastructure, Networks, etc is a separate cost & recovery of that has to be part of loan and deposit pricing decisions.



Liquidity:

- **if you don't have it you cease to be a bank**
- classic LPHI event
- business managers do not appreciate it
  
- Must be managed collectively by ALCO
- Cost of liquidity to be estimated and passed into businesses
- ALCO – ALM to **mandate** tactical and strategic liquidity rules



- Structural Interest Rate Risk management to be delegated to ALM
- ALCO to decide strategy – ALM to execute
- Profit and loss should be in ALM – ie separate from ‘Treasury’ or ‘Financial Markets’
- Performance evaluation requires deep understanding of markets, uncertainty & risk



This has many dimensions

- NII & NIM
- Total Profitability
- Return on Capital - this must be built into **ALL**
  - Loan Products
  - Non loan products
  - Relationship profitability
  - Product profitability
- 'Total Business' done is not an informative number!!